Working Lunch on Graduation from Concessional Finance:

Exchange with Member States in preparation for the 2018 report of the Inter-agency Task Force on Financing for Development

23 January 2018, 1 – 3 p.m., Delegates Dining Room, UNHQ

Summary

Overview

The South Centre and the Friedrich-Ebert-Stiftung, jointly with the Financing for Development Office of UN DESA, organised a working lunch on 23 January 2018 on the topic “Graduation from Concessional Finance – Exchange with Member States in preparation for the 2018 report of the Inter-agency Task Force on Financing for Development”. Delegates from 17 Member States attended the lunch, along with representatives of several member agencies of the Inter-agency Task Force. The meeting featured a keynote presentation by Annalisa Prizzon from the Overseas Development Institute (ODI) on different development graduation processes and their impact on countries’ access to development finance. There were also presentations from the World Bank and the Committee for Development Policy (CDP) Secretariat on graduation processes in the multilateral development banks and from LDC status, respectively (see Annex I for the programme). The OECD also shared key points on ODA graduation.

The ensuing discussion focused on the impacts of graduation and how to improve support to countries to smooth transition and avoid reversals. Discussion also considered the validity of existing graduation criteria and options for reform. The relative decline in official development finance as countries reach middle-income status and the multifaceted challenges not fully reflected in per capita income were the main concerns raised. Proposals for reform included strengthened support during transitions, including by more systematic engagement of UN country teams in helping countries plan transitions; consideration of broader and multidimensional measures of progress in assessing “graduation readiness”; wider use of existing exceptions, such as the small state exception across different agencies; and more general efforts for different actors to learn from each other’s processes and to move toward greater harmonization where feasible and useful.

The meeting will serve to inform the drafting of the 2018 report of the Task Force.

Detailed Summary

Keynote presentation and discussants

After welcoming remarks by the organisers, **Annalisa Prizzon, Senior Research Fellow at the Overseas Development Institute**, provided a keynote presentation on graduation processes and their implications for financing development, laying out different graduation processes, their consequences for graduating countries, and options for reform.

Graduation is relevant in several different contexts: i) graduation in the context of multilateral development banks (MDBs), where countries lose access to concessional financing, such as the World Bank Group's International Development Association (IDA), the African Development Fund of the African Development Bank, and the Asian Development Fund of the Asian Development Bank; ii) graduation from the Least Developed Countries (LDCs) status; iii) graduation from ODA eligibility as countries become high-income countries; and iv) graduation from assistance by specialized funds such as GAVI.

In all cases, per capita income is a key criterion. For LDC graduation, income is only one of three criteria - the Human Asset Index and an Economic Vulnerability Index are equally important components of the overall assessment. MDB graduation complements per capita income with an assessment of creditworthiness.

A country's categorization as a low-, middle- or high-income country is not directly related to graduation – it is instead an analytical classification by the World Bank, updated annually. However, they are an input to decisions on lending eligibility. At around $1,200, when countries are re-classified as middle-income countries, a graduation process from soft windows of MDBs is triggered. The move from middle-income to high-income on the other hand, at per capita incomes of around $12,500, triggers graduation from ODA eligibility.

Focusing on graduation from concessional windows of MDBs, the presentation highlighted several consequences and related concerns. First, as countries' per capita incomes increase, they first move to "blend" status and eventually lose access to concessional finance from the MDBs, while having greater access to other MDB facilities – in the case of the World Bank, non-concessional loans from IBRD and resources from the IFC. Graduating countries will also continue to receive ODA from bilateral sources. However, even with access to these additional resources, total official support to countries generally declines. Tax revenues increase as incomes rise, but they typically do not sufficiently compensate for the loss in international public assistance. Thus lower middle income countries often have less total development finance available relative to low income countries – the so-called "missing middle" problem.

Second, they are also faced with the “harder terms” of regular assistance by MDBs, even though maturities and interest rates are still significantly more favourable than market terms. Relatedly, the shift in financing sources tends to impact the sectoral allocation of international public finance, with less focus on social sectors such as health, which are often financed in grant form.

Third, per capita income is a limited measure of development, capturing the aggregate economic situation, but not social, equity, environmental or other sustainable development considerations. It does not take into account vulnerabilities and risks, such as those faced by small-island developing States, and can change rapidly, e.g. in the case of GDP rebasing.

Options for reform include a more systematic inclusion of non-income based criteria in processes where that is not already the case; a move toward “gradation” or lending conditions tailored to specific country circumstances; differentiated pricing for specific projects such as global-public good related projects; country specific exceptions such as the small State exception that exists in IDA; and earmarking of resources for certain sectors.

Björn Gillsäter, Special Representative to the United Nations of the World Bank Group, gave more details on the World Bank’s graduation policy. After laying out main functions and financing terms of the World Bank Group’s windows for highly concessional funding (IDA) and for regular assistance through the International Bank for Reconstruction and Development (IBRD), he focussed on IDA graduation criteria, the various steps in the graduation process, existing support measures and exceptions for specific countries.

IDA eligibility is dependent on a measure of relative poverty – GNI per capita below the IDA operation cut-off, which is currently $1.165 – and an absence of creditworthiness. Once a country exceeds the operational cut-off, and has a positive creditworthiness assessment by the IBRD, it becomes an IDA-blend country, and IBRD financing is phased in while IDA financing is gradually phased out. After a period of at least three years, a country can graduate to IBRD-only status. The full process typically takes around 6 years, and is accompanied by Graduation “Task Force’ that aims to ensure a smooth path of transition.

Several exceptions are in place. Small island economies remain eligible to access IDA funding even if they exceed income thresholds; funds from the concessional financing facility are available to middle-income countries that host large numbers of refugees; and India benefitted from a transitional support mechanism. Additional measures for transitional support are currently under discussion, including using proceeds of leveraging IDA’s equity to provide additional non-concessional financing to IDA gap and blend countries. Additional provisional support is also considered for three countries that have recently graduated – Bolivia, Sri Lanka and Vietnam.

Matthias Bruckner, Senior Economist in the Committee for Development Policy Secretariat, discussed the impact of graduation from LDC status on countries' access to financing, noting that affected countries are concerned by potential reduction in development finance flows, but that these effects seem to be limited in recent graduation experiences.

The presentation first briefly described the criteria determining LDC status – a multidimensional assessment based on per capita income, the human asset index and an economic vulnerability index. He also explained the role of the Committee for Development Policy (CDP) in recommending graduation from the category to the intergovernmental process. Similar to IDA graduation, the full process from the initial recommendation to final graduation takes around 6 years.

While difficult to assess (graduation from LDC status often coincides with graduation from IDA and other concessional windows), available evidence suggests that losing LDC status does not generally have a major impact on access to development finance. There are of course other support measures for LDCs, related primarily to trade and market access, whose loss is of great concern to graduating LDCs. In relation to development finance, bilateral donors have made several commitments on the quality and quantity of aid provided to LDCs, including in the Addis Agenda, but tend not to change allocations for a recipient country upon its graduation. Several UN entities also have specific targets for LDC funding – for example UNFCCC and UNCDF, but they usually continue support to countries even after their graduation from LDC status.

Nonetheless, countries are concerned over a possible reversal of development prospects upon graduation and loss of certain privileges associated with LDC status, calling for additional measures to ensure smooth transition. The UN system is already making efforts to support countries in this process, including through an LDC graduation Task Force.

Open discussion

The ensuing discussion focused on the impacts of graduation and how to improve support to countries to smoothen transition and avoid reversals; and on the validity of existing graduation criteria and options for reform.

Participants noted that the overall decrease in funding that countries seem to experience as they enter lower-middle income status – the "missing middle" phenomenon – was partially a function of low tax collection, but was also evidence for the continued reliance of middle-income countries on international public finance and MDB lending. Several countries at that stage of development had also accessed international financial markets, despite significantly higher costs of borrowing from markets. A number of possible reasons were identified, including that the supply of financing from non-concessional windows and other new sources may not be sufficient, that countries struggle to access funding from new and different actors or that they perceive the transaction costs as too high, or that they have borrowing constraints due to debt sustainability concerns. The appropriate policy response would depend on which factor was responsible for the relative drop in financing.

The “missing middle” challenge underlines the importance of a smooth transition process, and there were several calls to strengthen the support provided to countries as they undergo graduation. UN agencies already provide support to LDCs as they graduate through an LDC graduation Task Force. This could be a model for more systematic engagement of UN country teams in helping countries plan transition and provide support – particularly with a view to support their efforts to achieve the SDGs.

Such transition support may also help avoid drops in per capita income or loss of creditworthiness that would lead to reversals and readmission to concessional funding windows, even though such reversals have been rare. It would also reduce uncertainty and provide additional incentives for countries to seek graduation. Currently, the main incentive for graduation is its signalling effect.

Several participants noted the limitations of an income-only assessment of development and “graduation readiness”: even regarding economic progress, more comprehensive measurements were available, such as ECLAC’s structural gap approach, and GNI per capita also did not capture inequalities within countries. There were also suggestions to use broader assessments of progress – the Addis Agenda had in fact included a call to develop broader measures of progress that would take into account poverty in all its forms and the social, economic and environmental dimensions of sustainable development; the indicators for the SDG targets would also provide a more comprehensive assessment. At the same time, it was noted that existing processes already do go beyond per capita income – particularly in the case of LDCs, but also for graduation from MDBs’ soft windows, which use the creditworthiness criteria that take into account the broader macroeconomic situation, debt risks and other factors.

A second and related suggestion was to use broader measures of progress across processes and to achieve greater harmonization among them. One option could be to use existing exceptions such as IDA’s small state exception across different agencies, where that approach is appropriate and useful. More generally, participants saw room for different agencies and processes to learn from each other’s attempts to address diverse circumstances of countries and to achieve smooth transitions. The replenishment cycles of the concessional windows of the MDBs would be another entry point for achieving greater harmonization. The MDBs themselves have already formed a coordination group that could also discuss such issues, in response to calls in the Addis Agenda be responsive to the sustainable development agenda. In the context of LDC graduation, the CDP is currently reviewing the set of criteria. However, data availability remains a major concern for many proposed additional indicators.

ANNEX I: Programme

Welcome remarks

Ms. Bettina Luise Rürup, Executive Director, Friedrich-Ebert-Stiftung (FES) New York

Mr. Manuel Montes, Permanent Observer and Senior Advisor on Finance and Development, the South Centre

Ms. Shari Spiegel, Chief for Policy Analysis and Development, Financing for Development Office (Update on preparations for the 2018 IATF report)

Keynote presentation

Ms. Annalisa Prizzon, Senior Research Fellow, ODI

Discussants

Mr. Bjorn Gillsater, Special Representative to the United Nations, World Bank Group

Mr. Matthias Bruckner, Senior Economist, Committee for Development Policy Secretariat

Open discussion

Moderated by Mr. Oliver Schwank, Senior Economist, Financing for Development Office

ANNEX II: Concept Note

As many developing countries have or will graduate from concessional financing windows thanks to strong per capita income growth, concerns have been raised over their access to sufficient and affordable long-term financing for SDG investments. Extreme weather events and other external shocks have exacerbated these concerns, particularly in vulnerable countries. Underlying these concerns is the broader question of how to allocate increasingly scarce international public financial resources in light of large unmet financing needs.

In the Addis Ababa Action Agenda, world leaders committed to focussing the most concessional international public financial resources on those countries with the greatest needs and least ability to mobilize other resources, while also considering and addressing the diverse development needs of middle-income countries. As the Inter-agency Task Force noted in its 2017 report, these commitments could bring greater rationality to the allocation of concessional finance to countries and country groups.

Currently, such allocation remains largely uncoordinated from a global perspective, particularly in the case of bilateral official development assistance (ODA), and access to different financing sources is subject to diverse eligibility criteria and graduation processes – including graduation from concessional windows in the multilateral development banks (MDBs), from ODA eligibility, and, to a limited extent, from Least Developed Country (LDCs) status.

Several challenges arising from this “non-system” have been identified:

a. Bilateral ODA allocations are based on donor-country priorities. This fragmented aid landscape leads to both **“donor darlings”** and **“aid orphans”**, with per capita aid varying widely between recipient countries, and **decreases in aid to the most vulnerable countries** - despite commitments to the contrary, such as the commitment in the Addis Agenda to reverse the decline in ODA to LDCs.

b. Access to lending from MDBs is determined in a more systematic manner, and typically dependent on per-capita income levels and creditworthiness criteria. However, as countries’ per capita income increases above low-income thresholds, access to concessional finance decreases faster than can be compensated by increasing tax revenues or access to international financial markets, reducing overall public finance available to them (sometimes referred to as the **“missing middle” problem**). Accessing market finance also is associated with higher financing costs and refinancing and roll-over risks.

c. MDBs take into consideration factors beyond income levels to some extent, e.g. by granting exceptional access to small States. Nonetheless, many observers note that the specific structural challenges faced by Least Developed Countries (LDCs) and small island developing States (SIDS) merit additional attention. **Insufficient access** to official concessional finance **for vulnerable countries** with relatively high per capita income levels that continue to depend on support due to structural factors, or are vulnerable to external shocks, remains of great concern.

d. **External shocks** - such as extreme weather events or humanitarian crises – can **cause significant setbacks** even in countries that have reached high income status and have graduated from ODA eligibility, and in such cases **reinstatement for ODA eligibility may be warranted**, as recently noted by the OECD Development Assistance Committee.

The 2018 report of the Inter-agency Task Force laid out these challenges and their links to existing graduation processes (LDC status, ODA recipient status and MDB concessional windows), and will explore existing efforts and proposals to overcome them.

The working lunch served to introduce initial thinking by the Task Force to Member States, and provided space for an interactive discussion among delegates, Task Force members and experts.